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December 10, 2004

Mary L. Cottrell, Secretary
Department of Telecommunication and Energy
One South Station, 2nd Floor
Boston, MA 02110

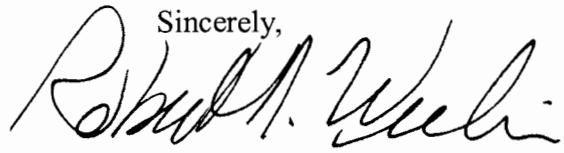
Re: D.T.E. 04-85 — Petition of Boston Edison Company and Commonwealth Electric Company for Approvals Relating to the Restructuring of Power Purchase Agreements with Northeast Energy Associates Limited Partnership

Dear Secretary Cottrell:

Enclosed for filing is the Reply Brief of Boston Edison Company and Commonwealth Electric Company, d/b/a NSTAR Electric in the above-referenced proceeding. Also enclosed is a certificate of service.

Thank you for your attention to this matter.

Sincerely,



Robert N. Werlin

Enclosure

cc: Joan Foster Evans, Hearing Officer
Service List

COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Boston Edison Company Commonwealth Electric Company	)	D.T.E. 04-85

CERTIFICATE OF SERVICE

I certify that I have this day served the foregoing document upon the Department of Telecommunications and parties of record in accordance with the requirements of 220 C.M.R. 1.05 (Department's Rules of Practice and Procedures).

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Dated: December 10, 2004

COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Petition of Boston Edison Company and Commonwealth Electric Company for Approvals Relating to the Restructuring of Purchase Power Agreements with Northeast Energy Associates Limited Partnership	)	D.T.E. 04-85

REPLY BRIEF OF BOSTON EDISON COMPANY AND COMMONWEALTH ELECTRIC COMPANY d/b/a NSTAR ELECTRIC

Submitted by:

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Dated: December 10, 2004

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REPLY BRIEF OF BOSTON EDISON COMPANY AND COMMONWEALTH ELECTRIC COMPANY d/b/a NSTAR ELECTRIC

I. INTRODUCTION

Boston Edison Company ("Boston Edison") and Commonwealth Electric Company ("Commonwealth"), d/b/a NSTAR Electric ("NSTAR Electric" or the "Companies"), file this reply brief in response to the initial brief of the Attorney General of the Commonwealth (the "Attorney General") in the above-referenced proceeding before the Department of Telecommunications and Energy (the "Department").[1] This case was filed by the Companies, pursuant to G.L. c. 164, §§ 1A, 1G, 76, 94 and 94A, for approval of: (a) the Bellingham Execution Agreement, dated August 19, 2004 between the Petitioners and Northeast Energy Associates Limited Partnership ("NEA"); (b) the four associated and Amended and Restated Purchase Power Agreements, two PPAs each between (1) Boston Edison and NEA and (2) Commonwealth and NEA (collectively, the

[1] In responding to the Attorney General's initial brief, the Companies will not repeat arguments at length that were addressed in the Companies' Initial Brief. Silence on any matter raised by the Attorney General does not indicate the Companies' agreement to any issue raised by the Attorney General. The Companies expressly reassert the positions and arguments set forth in their Initial Brief.

"NEA Restructuring"); and (c) ratemaking treatment associated with the NEA Restructuring (the "Petition").

The Attorney General raises three arguments against the Department's approval of the NEA Restructuring. According to the Attorney General: (1) the closing payment is subject to "too many uncertainties" to determine if the Companies are maximizing mitigation; (2) the Companies' and CEA's valuation of the existing PPAs, which relies on the Henwood Forecast, is flawed; and (3) the Companies' proposal improperly provides benefits to Boston Edison customers at the expense of Commonwealth customers (Attorney General Initial Brief at 5). As described herein, the Attorney General's arguments are not supported by either Department precedent or the record in this proceeding and should be rejected.

First, the Attorney General's focus on the amount of the Closing Payment is off-the-mark, reflecting a failure to understand how the Closing Payment Amount is determined and the manner in which it preserves the forecasted level of customer savings in the face of an uncertain closing date and fluctuations in the market price of power. Thus, while the Attorney General is right that the Closing Payment Amount will not be calculated until closing, his conclusion that savings projections are "speculative" is exactly wrong. It is by making an adjustment to the transaction economics at closing — to reflect the timing of the closing and the then-current market prices — that the likelihood of realizing projected savings is preserved. Second, the Attorney General points to no evidence supporting his contention that the Companies' and CEA's analysis of the NEA Restructuring is flawed. CEA and the Companies properly relied on the results of the Henwood Forecast, which continues to provide a reliable and independent

source of forecasted energy prices. Lastly, the Attorney General's argument that the NEA Restructuring improperly provides benefits to Commonwealth's customers at the expense of Boston Edison's customers is specious. The evidence demonstrates that the NEA Restructuring provides substantial benefits to Commonwealth's customers, while holding the customers of Boston Edison harmless. Accordingly, the Attorney General's arguments are without merit and should be rejected by the Department.

II. THE NEA RESTRUCTURING MAXIMIZES MITIGATION OF CUSTOMER TRANSITION COSTS.

A. The Closing Payment Amount Will Not Affect the NEA Restructuring's Maximization of Mitigation.

The Attorney General argues that it is difficult to determine if the Companies are maximizing the mitigation of transition costs because the final Closing Payment is unknown (Attorney General Initial Brief at 5-8). According to the Attorney General, the Company does not know when the NEA Restructuring will close or how much the actual Closing Payment will be at closing (id.). The Attorney General maintains that the Department's approval of the NEA Restructuring without knowing the Closing Payment Amount is equivalent to approving a "blank check" for the Company (id. at 8). However, the Attorney General's assertion that the Companies have not met their burden to maximize the mitigation of costs because the Closing Payment Amount is uncertain is without merit.

As an initial matter, Department had determined that a company demonstrates that it has maximized mitigation of a PPA if the mitigation proposal is the best alternative chosen as a result of an "auction process [that] provided complete, uninhibited, non-discriminatory access to all data and information by all interested bidders and that the

auction process was competitive, and, therefore, structured to maximize the value of the PPAs." D.T.E. 04-60, at 25; D.T.E. 04-68, at 19. The Department has already determined that the process used by the Companies meets that standard and the Attorney General has cited no evidence to contradict that finding or to suggest that any other proposal was superior to the NEA Restructuring. In addition, he has misconstrued the impact of changes in the Closing Payment.

The Closing Payment is designed to provide adjustments for changes that have occurred since the bid date on December 3, 2003 (Companies Initial Brief at 5). The Closing Payment has two components: (1) the Closing Date Amount, which calculates the difference between what NSTAR Electric actually paid under the existing PPAs from April 1, 2004 and what it would have paid under the Amended and Restated PPAs (Exh. NSTAR-GOL at 17-21; Exh. NSTAR-GOL-3); and (2) the Adjusted Bid Price Amount, which accounts for changes in wholesale energy market prices from the bid date of December 3, 2003 to the Closing Date (Exh. NSTAR-GOL at 18, 21-24; Exh. NSTAR-GOL-4). The Companies' updated base case assumes a Closing Date Amount of $53.61 million (RR-DTE-3, Attachment RR-DTE-3(a) at 1, line 21) and an Adjusted Bid Price Amount of ($72.08 million) (RR-DTE-3, Attachment RR-DTE-3(b) at 1, line 7), resulting in a Closing Payment Amount to be paid from NEA to NSTAR Electric of $18.47 million ($72.08-$53.61 million). A schematic representation of the components of the Closing Payment Amount is as follows:

Closing Payment Amount[2]	=	Closing Date Amount	+	Adjusted Bid Price Amount
($18.47 million)	=	$53.61 million	+	($72.08 million)

The Companies' calculation of customer savings from the NEA Restructuring includes the Closing Payment Amount of $18.47 million from NEA to NSTAR Electric. The customer savings total $52 million on an NPV basis (RR-DTE-3, Attachment RR-DTE-3(d) and Attachment RR-DTE-3(h), which update Exh. NSTAR-BEC-GOL-2 and Exh. NSTAR-COM-GOL-2 submitted in the initial filing). The savings to customers are determined by comparing the forecast Transition Charges to be paid by customers if the NEA PPAs were to remain in effect with the Transition Charges to be paid by customers under the NEA Restructuring.

The Attorney General argues that, if the Closing Date were not to occur until March 31, 2005, the Closing Date Amount would be $60.84 million rather than $53.6 million, as shown in the schematic above (Attorney General Initial Brief at 7, fn. 10). Although the Companies provided this estimate in response to Record Request AG-1, the Companies intend to close as soon as possible after the Department's order becomes final, long before March 31, 2005 (Tr. 1, at 93). The Attorney General has offered no evidence (nor is there any) to support the conclusion that the closing will occur on the last day in March 2005.

Moreover, even if the closing were to occur on March 31, 2005, the Closing Date Amount does not materially affect the amount of savings to customers resulting from the NEA Restructuring. The Closing Date Amount calculates the value of the difference

[2] A negative Closing Payment Amount means that NEA will pay NSTAR Electric the Closing Payment Amount

between the amount that would have been paid under the Amended and Restated PPAs and the amounts actually paid under the existing PPAs for the period between April 1, 2004 and the day of the closing of the NEA Restructuring (Exh. NSTAR-GOL at 18). April 1, 2004 was used because it was the reference date included in the NEA bid, and the Closing Date Amount is therefore designed to treat the transaction (i.e., the economics of the deal) as if the closing had actually occurred on April 1, 2004 (Exh. DTE-1-5). The Closing Date Amount does not change the economics of the NEA Restructuring; it simply accounts for the timing difference between April 1, 2004 and the date of the actual closing. So if the Closing Date Amount increases, there is a change in front-end payment because of the later closing date, but the total NPV savings do not materially change. The Attorney General incorrectly makes one adjustment to the calculation of NPV savings (to capture the larger front-end payment) without making a corresponding adjustment to reflect the decrease in payments over the balance of the transaction.

The Attorney General contends that because the Adjusted Bid Price Amount will not be final until the closing, and is sensitive to energy and natural gas prices, its fluctuation makes savings from the NEA Restructuring "purely speculative" (Attorney General Initial Brief at 6). This contention ignores the basis and intent of the Adjusted Bid Price Amount. The Adjusted Bid Price Amount is determined based on the NYMEX Henry Hub futures strips through the lives of the existing PPAs (Exh. NSTAR-GOL, at 21-24; Exh. NSTAR-GOL-4; Exh. NSTAR-1, Appendix A, at 432-435). Because of the interrelationship between future gas prices and other energy prices (including electricity) as contemplated by the NEA bid, which uses the NYMEX natural gas futures contract

and a heat rate of 8,600 BTU per KWh, it is not appropriate to look at a change in the Adjusted Bid Price Amount in isolation. If there were to be a large reduction in the NYMEX Henry Hub futures market (which would reduce the Adjustment Price Amount payments from NEA), there would also be a corresponding (and off-setting) reduction in the forecasted market price of electricity. Thus, a $52 million reduction in the Adjusted Bid Price Amount would not result in a $52 million reduction in customer savings. Rather, the reduction in the Adjusted Bid Price Amount would be offset by a reduction in the forecasted market value of the electricity produced under the existing contracts, increasing the above-market cost of those contracts and increasing the value of the restructuring savings to customers. The change in the Adjusted Bid Price Amount has in fact worked to preserve customer savings. Since the original bid date, energy prices have increased, which would decrease the savings of the restructuring. However, this decrease has been substantially been offset by the $60.3 million increase in the Adjusted Bid Price Amount (from NEA's bid date amount of $12.5 to the $72.8 million). Thus the adjustment to the Closing Date Payment makes customer savings less, not more speculative.

Moreover, the $52 million change posited by the Attorney General would require an unprecedented increase in the NYMEX prices over a very short period of time. At the time of the initial filing in this case, the calculated, uncapped, Adjusted Bid Price Amount was $48.307 million (Exh. NSTAR-GOL-4, Line 7, Column "No Cap" Total NEA). This was based on NYMEX Henry Hub futures prices as of August 19, 2004 (Exh. NSTAR-GOL at 21). The comparable number, based on November 11, 2004 data, is $72.084 million (RR-DTE-3, Attachment RR-DTE-3(b)). Even during this large run-

up in energy prices (which have since moderated), the change in the uncapped Adjusted Bid Price Amount was far less than the $52 million change suggested by the Attorney General.

By definition, the actual dollar amount of the Final Closing Payment will not be known until the closing date. But the savings associated with the NEA Restructuring are not "purely speculative," as claimed by the Attorney General (Attorney General Initial Brief at 6). NSTAR Electric customers are protected because of the asymmetrical band ($2.4 million maximum from NSTAR Electric compared to an $80 million maximum payment from NEA to NSTAR Electric) in the Adjusted Bid Price Amount. Given the historical correlation between the gas and energy markets, and in light of the fact that the NYMEX gas forward market is an identifiable, verifiable index, this mechanism is the most reliable means of preserving value in a changing market. Rather than being speculative, as charged by the Attorney General, the NEA Restructuring's use of an Adjusted Bid Price Amount provides a reasonable means by which the value of the transaction can be preserved to the greatest extent possible. If at the time of closing, the payment from NSTAR Electric is to be greater than $2.4 million, NSTAR Electric has a contractual right not to proceed to closing.

B. The Companies Have Reasonably Evaluated the Economic Benefits To Be Obtained From the NEA Restructuring.

The Companies' auction consultant, CEA, evaluated the NEA bid and the market value of the existing NEA PPAs based on the Henwood Forecast of future electricity prices. The Attorney General argues that CEA does not know how the Henwood Forecast incorporates the increased value of capacity that would result from a recently proposed ISO-NE Locational Installed Capacity ("LICAP") tariff, now before the Federal

Energy Regulatory Commission (the "FERC"). Thus, the Attorney General suggests the Department reject the NEA Restructuring and "advise the Company to wait" until the value of the existing NEA PPAs can be enhanced by the LICAP proposal after it is approved by the FERC (Attorney General Initial Brief at 12-13).

First, it must be noted that the Attorney General has formally joined the Companies and others *in opposition to* the LICAP proposal before the FERC (see Exh. AG-1, which is the prefiled testimony jointly sponsored by NSTAR Electric and the Attorney General that, if adopted, would have the FERC deny the implementation of LICAP). If the Companies and the Attorney General prevail before the FERC, the Henwood Forecast would clearly overstate the price of electricity and customer savings from the NEA Restructuring would be higher.

Moreover, the Companies and the Department have relied on the Henwood Forecast as a stand-alone independent forecast, and have not attempted to "carve out" various individual adjustments to the assumptions and inputs used by the Henwood Forecast in order to analyze the value of the NEA Restructuring, or any other purchase power agreement restructuring or termination. As the Department has noted previously, "the Henwood forecast is a widely-available and reasonable proxy for a forecast of the price of electricity." Pittsfield at 26. The Companies have relied on the Henwood Forecast because it is an industry-known, independent, third-party forecast of the key energy variables that has been relied on by NSTAR Electric and the Department in the past (Exh. DTE-2-9 [D.T.E. 04-60]). The Henwood Forecasts have historically fallen between other well-regarded market forecasts (Exh. AG-3-10, Attachment AG-3-10(b) **CONFIDENTIAL** [D.T.E. 04-60]).

The Attorney General acknowledges that the Henwood Forecast of electricity prices addresses the ICAP market in New England (Attorney General Initial Brief at 9, *citing* Exh. AG-1-36(a) (Supp), Section 5, Results). See also Tr. 1, at 115 (the Henwood Forecast has addressed the issue of the value of locational capacity). It should be noted, however, that the Henwood assumptions regarding capacity values represent only a small subset of the totality of assumptions underlying Henwood's Fall 2004 Forecast. There are many other assumptions (see Exh. AG-1-36 (Supplemental), Att. AG-1-36(a) (Supp) **CONFIDENTIAL BULK**, Chapter 4), which individually or in aggregate are likely to have an equally significant effect on the market price forecast. The purpose of using a third-party, independent reference-case forecast, however, is to accept the results without manipulating such key assumptions or methodologies.

Moreover, resolution of the appropriate manner of dealing with LICAP in a forecast requires assumptions about the outcome of the FERC proceedings and how that outcome will translate into future costs in the electricity market. Although the Henwood Forecast has attempted to incorporate such assumptions in its electricity price forecast by including the value of capacity, there is no way that the Department can reconcile those assumptions with the *ad hoc* scenarios suggested by the Attorney General.

In preparing an answer to the Attorney General's record request, CEA and the Companies endeavored to be responsive, but indicated that CEA was not provided with the specific method by which the Henwood Forecast quantifies capacity values in their forecast, nor is CEA aware of the method, if any, by which the values contained in Table 5-4 of the Henwood Forecast narrative are specifically incorporated in the forecast. That is hardly surprising since the forecast methodology is proprietary and constitutes a

significant competitive and strategic asset for the developers of the forecast. However, this is not to say that CEA lacked understanding about the approach taken in the Henwood Forecast and made reasonable assumptions in preparing the response to Record Request AG-3.

As described in the Henwood Forecast, it has included the value of capacity by "co-optimizing energy and capacity market revenues to arrive at a long-term ICAP value" (see Exh. AG-1-36 (Supp), Att. AG-1-36(a) Supplemental, page 5-20). This explanation is consistent with CEA's description of the methodology by which the Henwood Forecast includes the value of capacity; as Mr. Hevert noted during cross examination: "[t]he [forecast] price is not necessarily the marginal cost of the marginal unit, but it is the price at which that owner would cover not only their marginal costs but also the fixed costs of owning capacity" (Tr. 1, at 108). As noted on Exhibit AG-1-36 (Supp), Attachment AG-1-36(a) Supplemental, page 3-3, the Henwood Forecast's "simulation process produces an all-in price for the energy market. There is no separate calculation for capacity beyond limited provisions for various ancillary services. Thus, in modeling the bidding of generators, provision must be made for the recovery of all economic costs through the price of electricity." Thus the Attorney General's assertion that "CEA's failure to understand how a significant cost component is reflected in the market prices used to value the NEA agreements represents a major, if not fatal, short coming of the economic analysis of the proposal" (see Initial Brief of the Attorney General at 9) is misleading and without merit.

The Attorney General's criticisms of CEA's assumptions in replying to Record Request AG-3 are also without merit. For instance, since capacity values are generally

stated in terms of $/kW-years (or $/kW-months) for a given amount of generating capacity and the Henwood Forecast market prices are stated in terms of kWhs, it is necessary to convert the capacity value amounts to a $/kWh basis. Thus the capacity values must be spread over the relevant number of kWhs in order to calculate the adjusted market price. As it relates to NEA, the relevant measure of production is the product of the plant's capacity and its capacity factor. As noted in the Companies' response to Record Request AG-3, "CEA…converted the ISO-NE LICAP values contained in Mr. Daly's testimony to a $/kW-hour basis by assuming the NEA facility's average capacity factor of 95 percent" (see also Exh. AG-1-12 and Exh. AG-1-13 (Revised)). Since CEA's analysis used the all-hours SEMA-RI forecast, it is necessary to extract the capacity values based on a system-wide (i.e., incorporates both peak and off-peak resources) average annual capacity factor because the all-hours price contains capacity from a variety of plants that make up the price forecast. For instance, some plants run at base-load capacity factors, some at intermediate capacity factors and some at peaking capacity factors. Therefore the capacity price has to be a weighted average of all these plants. CEA's analysis was based on the historical average of the ISO-NE monthly load factors of 62 percent (RR-AG-3).

Accordingly, the Attorney General's arguments that Companies have not properly calculated customer-savings forecasts have no factual basis. The customer-savings projections are based on the updated Henwood Forecast, which the Department has consistently found to be reliable and independent. The Department should reject the Attorney General's argument that the Companies' and CEA's evaluation of the existing NEA PPAs is flawed.

C. The Companies' Proposal to Reallocate the Savings Is Reasonable and Maximizes the Mitigation of the Existing NEA PPAs.

Although the NEA Restructuring provides significant savings to customers, recent changes in the forecasted market prices results in a substantial reallocation of estimated savings among the various contracts and would produce negative savings for customers of Boston Edison (Exh. AG-1-37, at 2). In order to eliminate the negative impact on customers of Boston Edison, while still leaving significant savings with customers of Commonwealth, the Companies proposed to reallocate the savings as set forth in the response to Record Request DTE-3 (Tr. 1, at 61-62). Based on this reallocation, the vast majority of the savings are returned to the customers of Commonwealth, while holding harmless the customers of Boston Edison.

The Attorney General attacks the Companies' proposal arguing that it improperly provides benefits to Boston Edison's customers at the expense of Commonwealth's customers (Attorney General Initial Brief at 13). According to the Attorney General, the Department generally rejects the subsidization of costs by one group of customers for another (id.). The Attorney General's charge is inapposite to the facts of this case in which the Companies' proposal is to allow one company to share *a benefit* rather than to allocate the burden of a cost through a subsidy.

Unlike a rate case, in which a company's costs are allocated among customer classes, this case offers an opportunity for the customers of Commonwealth to obtain significant savings, even in the face of recent changes in the forecasted market prices for energy. Equity favors approval of the Companies' proposal because neither group of customers would be harmed, and Commonwealth's customers would obtain a substantial benefit. See Eastern Enterprises/Colonial Gas Company, D.T.E. 98-128, at 84-85 (1999)

(Department evaluates whether the distribution of benefits between customers and shareholders is fair based on no net harm to customers). The Attorney General's suggestion that it is somehow more fair to reject the NEA Restructuring in total is unsupportable because it would significantly harm Commonwealth's customers (by denying them the benefit of significant savings), while leaving Boston Edison's customers in an unchanged position.

The Department should approve the NEA Restructuring, thereby maximizing the mitigation of the above-market power costs associated with the existing NEA PPAs.

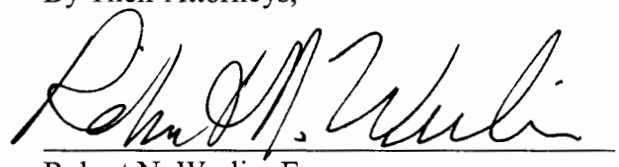
III. CONCLUSION

For the reasons set forth herein and in the Companies' Initial Brief, the Department should approve the Companies' Petition.

Respectfully submitted,

BOSTON EDISON COMPANY AND COMMONWEALTH ELECTRIC COMPANY

By Their Attorneys,



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